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ES/MI # 548

14 December 1984

MEMORANDUM FOR: See Distribution

SUBJECT : Meetings

2. A/NIO/EA



Type of Meeting : SIG-IEP
Date : Tuesday, 18 December
Time : 11:00 - 12:30
Place : Roosevelt Room
Chaired By : Secretary Regan
Principal Only? : Plus one
Subject/Agenda : (1) US-USSR Working Group (subject of SIG-IEP postponed last week (13 Dec.)
(2) US-Japan Economic Issues

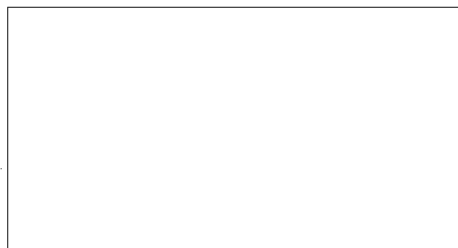
When to Expect Papers : We have rec'd papers on the USSR topic. The Japan issues will be sent soon.
Time Info Received : Per Sonya, Treasury, 10:00 a.m.

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United States Department of State

Washington, D.C. 20520

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*note SIG IEP
tentatively scheduled
for 18 December
NSC consideration
21 December*

INDEX TO PAPERS

1. Inter-Agency Working Group Strategy and Agenda Paper
2. Suggested Talking Points -- Bilateral Issues
3. Suggested Talking Points -- International Issues
4. Background Papers:
 - a. Japanese Political Situation
 - b. Japanese Economic Situation
 - c. Bilateral Trade Relations (with Issues Checklist)
 - d. Finance Issues*
 - e. Defense/Security Issues Checklist
 - f. Japanese Foreign Policy
 - g. S&T Issues
 - h. Pacific Cooperation*
 - i. Energy Issues
 - j. Arms Control Issues**
 - k. Japanese-Soviet Relations
 - l. Key Recommendations of U.S.-Japan Advisory Commission

* New paper

** Not yet received

*SIG-IEP
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INTER-AGENCY WORKING PAPER
STRATEGY AND AGENDA FOR THE PRESIDENT'S JANUARY 2 MEETING
WITH JAPANESE PRIME MINISTER NAKASONE

SETTING

The President's January 2 meeting with Prime Minister Nakasone will be his fifth in two years and comes at a time of growing frustration over Japan's failure to respond fully and promptly to our repeated calls for equitable access. During the past two years, and especially since the President's November 1983 trip to Japan, we have made significant progress in strengthening our ties with this important Pacific nation and creating the "international partnership" that Secretary of State Shultz envisaged in his Shimoda Conference speech. Coming at the beginning of the New Year and second terms in office for both leaders, this meeting presents an excellent opportunity to build upon the momentum of the past two years and set the agenda and tone of our relationship for the next year and beyond. The President has indicated that he wants this meeting to reaffirm and strengthen our crucial bilateral relationship with Japan, while discussing candidly those areas -- particularly in our economic relationship -- where substantial progress is needed to preserve our forward momentum as Pacific partners.

Many areas of our relationship are marked by a cooperative spirit and concrete results. Our relationship and policy cooperation serve as the linchpin of American security and political influence in the East Asian region. Our security ties and our cooperation on regional issues, including Korea and China, have been excellent. Japan has closely coordinated its Soviet policy with us, been extremely supportive of our position on arms control, and cooperated fully with specific requests to stem the flow of high technology to the Soviet bloc. Japan has become the world's third largest aid donor and in response to our requests is directing more of its assistance into regions of strategic importance to the West. U.S. exports to Japan, already our largest overseas market, have increased this year by 10%; Japan again leads the list of new foreign investors in the U.S., providing jobs to Americans; we secured a landmark agreement on capital market liberalization and internationalization of the yen; and the April 27 trade package and agreement to expand beef and citrus quotas dealt with a number of American requests. Popular attitudes in both countries also are favorable: the Japan Socialist Party is moving to strengthen its ties to the U.S. and pursue more balanced policies; and in the U.S., public opinion polls show that popular attitudes

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-2-
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toward Japan are highly favorable, with Japan cited as the "most liked" and "most important" country in the world, just after Canada and Great Britain.

On the negative side, however, we are faced with a growing trade deficit with Japan -- over \$30 billion in 1984. Despite years of efforts, import penetration in Japan is low, especially in manufactured goods. Only 13% of Japan's domestic consumption is accounted for by imports, compared to 23% in the U.S. Japan's imports of manufactures are lower on a per capita basis and as a share of GNP than any of the other industrialized nations. Progress has been frustratingly slow and incomplete in implementing many of Japan's commitments, as the Administration's report to Senator Percy recently indicated. Certain high tariffs and residual import quotas on agricultural products continue to restrict U.S. market access; and the Japanese Government continues to employ policy tools to thwart our comparative advantage in high technology products and services. Failure to overcome obstacles to the achievement of our objectives in these fields -- trade, finance, and energy -- could complicate and hamper our broader bilateral agenda for progress. Pressures on our Japan policy and demands that something "dramatic" be done will mount in the months ahead, and there is an urgent need for effective action. We must maintain the mutual confidence and trust in the relationship, while at the same time accomplishing our trade goals, which are essential to our national economic interest.

OBJECTIVES OF THE MEETING

In the President's meeting with Nakasone, we have the opportunity to tackle aggressively major outstanding issues, and to establish a much more stable and long-term foundation for U.S.-Japan relations. Using the report of the U.S.-Japan Advisory Commission as the starting point, we can begin to explore in a creative and far-sighted manner how we can fulfill our long-term national interest in strengthening our ties with Japan across the full spectrum of our relationship -- bilateral economic and security ties, science and technology, and international political and economic cooperation. The two countries' leaders should endorse the basic thrust of the report and call on their two governments to get together at the working level to discuss how to implement its specific recommendations. We should also look at the excellent work of other binational groups, such as the Trade Study Group and the Japan-U.S. Businessmen's Conference.

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-3-
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We will want to cover three broad areas during the President's meeting and luncheon with Nakasone: bilateral economic relations, our mutual interest in world peace and regional stability, and closer U.S.-Japan cooperation on international political and economic issues. Press and public interest will be greatest on the specific topics of bilateral trade and arms control.

1. Our Bilateral Economic Relationship

Japan is a key player in the international economic system, but its participation is not balanced -- it is not a full participant in the international adjustment process. In particular, the Japanese economy does not accept foreign manufactures to a degree commensurate with the full play of market forces. Japan should be importing on the basis of market criteria rather than on considerations of national industrial policy or whether Japanese-made products are available. While we recognize that there is a structural component to the Japanese trade surplus, its size and the small share of manufactures imports reflect impediments to market forces and need to be addressed. We want to work with the Japanese to identify and remove, in accord with market forces, all barriers which impede access to the Japanese market, for an initial list of beachhead sectors, such as telecommunications and electronics. The final goal of this intensive process would be to open up the entire Japanese market to market forces.

As Administration spokesmen so often have stated, our trade policy towards Japan focuses not on eliminating the bilateral trade deficit, but on obtaining the same access to Japan's markets that Japanese companies have to ours. However, we will want to make sure that Nakasone understands that the mounting trade deficit will intensify the pressures on us for dramatic results. We must gain Nakasone's commitment that we must mutually work to find means to resolve economic disequilibrium in our relations. We will want to point out that we continue to be very concerned about the ability of many of our companies and industries to compete in Japan on an equal footing. The President will want to seek Nakasone's renewed commitment that in the months ahead, we will accelerate our efforts to resolve the specific issues that American business faces in Japan, placing a special focus on high technology. We should seek Nakasone's agreement with three specific recommendations of the U.S.-Japan Advisory Commission -- that market access should be made a national goal in Japan; that Japanese policies should be openly formulated and implemented, with ample opportunities provided for foreign firms to present their views; and that existing commitments should be fully and promptly implemented.

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-4-
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Our bilateral economic relationship with Japan is not strictly one of problems, however. U.S. exports to Japan -- already our largest overseas market -- have increased this year by over 13 percent, and Japan continues to be one of the largest investors in the United States, creating new jobs for Americans. The President and Nakasone will want to commit ourselves anew to seek further progress, promoting new cooperation and implementing existing arrangements in a number of areas -- high technology and other trade opportunities, capital market liberalization, internationalization of the yen, two-way investment, energy cooperation, and foreign economic assistance.

2. The Search for World Peace and Regional Stability

Japan is interested in improving its very frosty relations with the Soviet Union, but only in step with us. Nakasone therefore will be intensely interested in Secretary Shultz's upcoming meeting with Gromyko and what this portends for both U.S.-Soviet relations and arms control prospects. We will want to stress that our desire for an improvement in relations with the Soviets does not lessen the need for vigilance and strengthened defense efforts in either Japan or the United States. Given nascent indications that North and South Korea are testing the waters for reducing tensions, we will want to stress the need for close coordination on our actions among South Korea, Japan, and the U.S.; we will also want to stress the value of the bilateral process between North and South Korea, without any disruption from elsewhere. Finally, Nakasone will be interested in our views on developments in China and the Philippines, and our policies there.

3. Cooperation on International Political and Economic Issues

U.S.-Japan policy coordination on international issues is superb. While there are some shades of difference in specific regions -- most notably Iran-Iraq and relations with Israel -- we and the Japanese are basically on the same "wave length." Nakasone personally continues to be very supportive of the President's policies and recently told a Japanese television interviewer that "in Reagan you find everything that is good in genuine U.S. traditions." In our meeting with Nakasone, we will want to outline our thinking on Central America, the Middle East, the new trade round, and Pacific Cooperation. On this last point, Japanese officials have told us that Nakasone wants to make Pacific cooperation a centerpiece of the January 2 meeting. We will want to emphasize that while we have a

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-5-
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strong interest in the Pacific, Pacific cooperation is a long-term process, not susceptible to dramatic headlines or master plans imposed from Washington or Tokyo. Given the sensitivities of the other Pacific nations and our European allies -- and recent Soviet charges that the U.S. and Japan are out to create a new regional military alliance -- the United States and Japan must exercise careful and quiet leadership, and not attempt to force the pace of cooperation or seek to impose on the process more substance than it can bear. The process will probably not evolve without U.S. and Japanese impetus, but the ideal is for it to appear as an exercise in consensus-building with a strong ASEAN stamp on the process.

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-6-
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AGENDA FOR THE MEETING

We believe that we should focus on four general areas during the meeting and the luncheon. These are listed below, with an indication of the topics and talking points to be covered in each area:

I. Bilateral Relationship (General)

--USJAC report

II. Bilateral Economic Relationship

-- Market Opening: Trade
-- Market Opening: Capital Markets and Yen
 Internationalization
-- High tech issues
-- U.S. deficit, interest rates (Japan will raise)
-- Energy cooperation
-- Investment
-- VRA (Japan might raise)
-- whale arrangement

III. Search for World Peace and Regional Stability

--Japanese Defense
--Soviet relations
--Arms control
--Korean Peninsula
--Export control/tech leakage
--New Zealand port access
--Northern territories

IV. International Partnership

-- aid to LDC's (and Japanese imports from LDC's)
-- China
-- Philippines
-- Pacific Cooperation
-- Middle East
-- Central America and Caribbean
-- Africa
-- new trade round
-- energy security

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SUGGESTED TALKING POINTS FOR YOUR MEETING
WITH PRIME MINISTER NAKASONE -- BILATERAL ISSUES

-- We have made significant progress in strengthening the full spectrum of our relationship. I appreciate your personal role in this process. We must build on the momentum of the past two years to create a true "international partnership."

--There is, however, a paramount problem with which we must deal: the perception in the United States and other countries that Japan has a closed economy and its participation in the world trading system is not balanced.

-- We also face a serious problem in our bilateral economic relations. The size of our trade deficit is politically explosive in the United States. I recognize that there are macroeconomic causes for the increase in our trade deficit -- exchange rates and strong economic growth in the U.S. -- but such a large deficit with any one country is politically dangerous. I am concerned that this situation can undermine the excellent relations between our countries and harm the world trading system.

-- We also recognize that there is a structural component to Japanese surpluses, based on Japan's need to import food, raw materials and fuels, and to export manufactures. Nonetheless, the size of your surpluses and the small share of manufactures appear to us to reflect impediments to market forces.

-- I know that you want to make Japan in word and deed the most open market in the world, and a leader in strengthening the international trade system. But Americans believe in results. Many of my country's officials and businessmen are frustrated by the slow pace of progress. We want to see your commitment to an open market carried out at every level of your Government.

-- We want to work intensively with you to identify and remove all barriers which impede foreign access to the Japanese market in accord with market forces. To start this process, I propose that we commit our governments to start negotiations on full, free market access for imports in selected sectors in the Japanese economy, as we did in the yen-dollar talks, where your commitment made success possible.

-- I propose that we start with the following sectors: telecommunications, electronics, forestry products, medical supplies and equipment, and chemicals.

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-2-

Issues from November '83 Visit

-- The yen-dollar agreement was one of the most significant developments in our economic relationship. Although considerable progress has been made, further action is needed to fulfill the agreement. Let us move aggressively to implement it fully.

-- I am pleased to see more investment from Japan in the United States and would welcome more investment in Japan.

-- We are disappointed with the progress to date on energy cooperation. Our energy experts will meet several times soon, and we very much hope to see concrete progress on coal and natural gas before the subcabinet talks in late February or early March.

-- (If raised) We will work toward a modification of current restrictions on Alaskan oil exports, but this remains a controversial issue in Congress.

-- The report of the U.S.-Japan Advisory Commission is an excellent framework for strengthening our relationship in the future. We should endorse its thrust and have our two governments get together to discuss implementation of its many recommendations. We also should look at the views of other binational private groups such as the US-Japan Businessmen's Conference and the Trade Study Group.

-- I hope that you will commit Japan to a central recommendation of the Advisory Commission -- that market access should be made a national goal in Japan; that Japanese policies should be openly formulated and implemented, with ample opportunities provided for foreign entities to present their views; and that existing commitments should be fully and promptly implemented.

-- (If raised) I am committed to reducing our budget deficit and getting interest rates down even further.

-- (If raised) The decision about auto export restraints is Japan's to make. I agree that it is best to wait-and-see and monitor the state of our auto industry and the trade environment.

-- (If raised) I am pleased that we concluded an arrangement on the difficult whaling issue. I hope it will be implemented in full.

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SUGGESTED TALKING POINTS FOR YOUR MEETING
WITH PRIME MINISTER NAKASONE -- INTERNATIONAL ISSUES

-- We should expand further our defense cooperation in 1985. Japan is making progress. However, the need remains great and the 1985 budget effort, while significant and appreciated, will not go as far as necessary. I hope Japan will intensify its efforts to carry out its defense roles and missions as soon as possible within this decade.

-- As I mentioned to you last year, we have a continuing need for an alternate landing site for our aircraft carrier Midway's might landing practice. Despite the domestic difficulties involved, our need is still immediate, based on safety.

-- We share Japan's concerns about the Soviet military build-up in the region, including in the Northern Territories, and Soviet overflights of Japanese territory.

-- We will continue to support Japan's position on the Northern Territories issue.

-- The talks next week between Secretary Shultz and Gromyko will be difficult, but I am determined that the talks will produce results. We will pay the closest attention to the interests of Japan and our allies as the talks proceed.

-- It is important for Japan to continue its efforts to tighten controls on the transfer of sensitive technology to the Soviet bloc.

-- We welcome the North-South talks in Korea, and believe this direct process should continue without outside disruption. Given developments in Korea, the closest coordination among Japan, South Korea and the U.S. is essential.

-- When you visit New Zealand, I hope you will stress the importance that Japan attaches to ANZUS and the contribution it makes to our common security interests.

-- I hope that we can strengthen cooperation on economic assistance to Africa and Latin America. This assistance can provide political and economic benefits to our common interests and also to the peoples of those regions.

-- I am glad that Japan is increasing foreign assistance. But Japan can aid the LDC's also by increasing imports from them. The U.S. currently takes 50% of all LDC exports. We need strong support from other advanced industrial nations, particularly Japan.

-- I appreciate Japan's efforts to continue to seek ways to reduce the level of conflict between Iran and Iraq.

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-2-
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-- We continue to be concerned about the Philippines. I appreciate Japan's efforts to support the Philippines. We should consult closely and look at further ways of helping the Filipinos deal with their political and economic difficulties.

-- We welcome greater Pacific cooperation, but it is a long-term process, in which other countries have a significant role. Given the sensitivities of other nations, we must move with deliberation and close consultation, not with dramatic public gestures.

-- We should re-double our efforts to launch a new international trade round as soon as possible.

-- On energy security, we would be most concerned if Japan were to buy Soviet (Sakhalin) gas, especially since competitive U.S. sources are available. Also, we hope Japan will accelerate its purchases of oil for its strategic reserve.

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JAPANESE DOMESTIC POLITICS

On October 31, 1984, Prime Minister Nakasone won Liberal Democratic Party (LDP) approval for a second (and under current party rule, final) two year term as LDP President and, therefore, Prime Minister. Nakasone's third Cabinet, appointed the same day, contains enough talent and expertise to enable him to deal effectively with a full agenda of domestic and foreign policy issues, including trade and defense issues with the United States. Public opinion polls show unprecedentedly high marks for Nakasone, but given the nature of internal LDP politics, he will have to watch his flanks very carefully.

Both Foreign Minister Abe and Finance Minister Takeshita retained their portfolios, ensuring not only policy continuity but also maintenance of good working relationships with U.S. counterparts established over the last two years.

Several important legislative objectives, including the budget process and educational, fiscal, and administrative reform measures, will claim Nakasone's attention during the current Diet session. However, much of the Cabinet's important groundwork already has been laid. In the absence of any major disagreements with the opposition parties, Nakasone will be free to concentrate in the near term on Japan's international relations, including the U.S.-Japan relationship.

While U.S.-Japan trade heads the list of key issues for Nakasone in the months ahead, the opposition parties may force him to focus on two defense issues as well. The first of these is the defense budget, which may spill over the 1% of GNP breakwall in FY 1985, sending the question of defense spending into uncharted waters. The second involves opposition party victories in recent mayoral elections, which could impact adversely on construction programs for U.S. forces. Although some have viewed these elections as evidence of growing discontent with the U.S. military presence in Japan, we believe the issues involved are essentially environmental and are not directed specifically at U.S. military operations in Japan. While both these issues will require careful handling, public opinion polls continue to record overwhelming support for a close U.S.-Japan security relationship.

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JAPANESE ECONOMIC SITUATION

Japan weathered the second oil shock of the late seventies and the protracted international recession that followed better than any other major industrial country. Growth has remained higher than elsewhere, inflation has been kept under control and, in spite of some increase, unemployment has stayed very low by international standards. With a strong resurgence of exports in 1983 and subsequent signs of strengthening domestic demand, the Japanese economy entered a period of renewed expansion.

Led by brisk exports and strong private capital spending in plant and equipment, the Japanese economy in 1984 has performed better than expected, achieving an annual GNP growth rate of 5.3%. As a result of strong exports, especially to the U.S., Japan's current account surplus this year is projected to reach \$33 billion; the growth rate of these surpluses may slow down but it will remain at a high level, nonetheless, about \$37 billion in 1985. Wage moderation and stable commodity prices make it likely that consumer price inflation will stay at around the current 2.6% level through next year. While high by Japanese historical standards, unemployment has remained at around 2.7% since mid-1983 and may rise slightly next year. Private consumption, which accounts for nearly 60% of GNP, lagged behind the recovery elsewhere in the economy until recently, but is reviving somewhat because disposable income has been stimulated by added overtime work and a small income tax cut. Private housing investment, on the other hand, remains sluggish.

Most observers expect that continued vigorous business spending along with a recovery, even if small, in consumption and residential investment will sustain the forward pace of the Japanese economy during 1985. Slackening export growth partly counterbalanced by increasing domestic demand should result in GNP growth of about 4.2%, although this could be lower if there is a slowdown in the U.S. economy.

Aided by financial deregulation by the Japanese government, there has been a large outflow of Japan's surplus saving to the United States in search of higher returns. As a result, the yen has weakened by two percent against the dollar since May 1984. However, it has appreciated ten percent against the DM and is near its historic high over the longer term. We expect the yen to strengthen against the dollar as Japanese demand for dollar investments is saturated and freer financial policies in Japan result in greater foreign demand for yen.

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US-JAPAN TRADE RELATIONS

Overall U.S.-Japan trade relations are strong. As the two largest and most dynamic industrial democracies (together accounting for one third of world GNP), our economies are increasingly interdependent. With over \$85 billion in bilateral trade in goods and services expected this year, Japan is our largest trading partner after Canada. A huge market for U.S. agriculture and a wide range of manufactured products, Japan receives almost 11% of our exports. The U.S. is Japan's principal market, buying 29% of all its exports. Bilateral long-term capital flows also are increasing, especially through Japanese direct investment in the U.S., which now exceeds \$11 billion. (U.S. direct investment in Japan totals about \$8 billion.)

Bilateral trade relations have been tense over the past several years, however, and remain a major political problem. Our growing trade deficit with Japan (expected to exceed \$30 billion this year as compared to \$19.3 billion in 1983), the fact that Japan's market is generally less open to U.S. products than our market is for Japanese goods and services, and Japan's obvious success in the U.S. and other markets raise questions about our trade relations with Japan. The Administration's goal has been and remains one of market-access for U.S. goods, services and investment in Japan similar to that enjoyed by Japan in our market.

← strength

Since late 1981, the GOJ has adopted five market-opening trade "packages" which have reduced some tariffs, streamlined customs procedures, revamped product standards and certifications, stimulated telecommunications procurement from abroad and expanded beef, citrus and other import quotas. The most recent package in April should help market opportunities for competitive American tobacco, telecommunications, paper and wine products. While these unilateral measures have improved foreign access to the Japanese market, their full impact will depend heavily on how and how quickly they are implemented. ~~Our~~ trade prospects will also depend on the yen-dollar relationship, interest rates, US productivity and competitiveness, and the effectiveness of US business in developing markets in Japan and elsewhere.

Remaining difficulties to market entry in Japan include high tariffs on items such as processed wood products (in which the U.S. is competitive), certain import quotas, restrictive government procurement policies, and bureaucratic, commercial and cultural attitudes favoring domestic products. The U.S. is working to eliminate impediments to full access in Japan for foreign investment and services, telecommunications products, computer software and satellites. We have also encouraged Japan to liberalize its capital markets and promote a greater international role for the yen. Over time, these measures should allow the yen to play a role in international finance more commensurate with Japan's economic strength and strengthen its value vis-a-vis the dollar to help make U.S. exports more competitive in Japan.

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Checklist of Key Trade Issues

Telecommunications: We have been pressing to ensure that when Japan implements its new legislation to liberalize its telecommunications market, standards, certification and registration requirements do not discriminate against foreign companies. We also want our market share in equipment and services to increase. Our objective is to have a system no less open than that currently followed by NTT; our ultimate goal is to see a system in place which is as liberal as the U.S. Present indications are that when the legislation becomes effective on April 1, Japan will have requirements which inhibit foreign participation in its telecommunications market.

Tariffs: We have been pressing the GOJ to eliminate or reduce a number of tariffs which are major obstacles to increased US exports. A renewed USG request made in August 1984 indicated particular interest in forest products, aluminum products including aircraft skins, paper products, fresh grapefruit, wine, walnuts, arimid fiber, and photographic paper. Although the GOJ will take action on some of these requests by April 1, we continue to seek accelerated or further reductions in tariffs. To date the GOJ has indicated that there is little prospect that additional cuts for next April will be made.

Standards and Certification: Standards-related measures have been contained in every GOJ trade package since 1982, and the statutory and regulatory framework for implementation has been completed. While good progress has been made in improving certain practices, implementation has been slow and incomplete and the USG has expressed serious concern about the lack of progress toward full implementation.

Tobacco: The Diet's tobacco reform bill, passed in August, will enable U.S. tobacco firms to import and distribute (but not manufacture) their products in Japan independently of the Japan Tobacco and Salt Public Corporation (JTS), effective April 1, 1985. Our interest is to ensure that no unreasonable burden is placed on U.S. firms when regulations are promulgated.

Computer Software: We have been pressing the GOJ to retain copyright protection for computer software. MITI proposed placing it under patent protection and has not given up its efforts to promote such a regime. Such a move would place U.S. software firms at a disadvantage in the Japanese market. We have underscored the seriousness with which we would view any move to change the current Japanese system.

Automobile Export Restraints: The voluntary auto export restraints--1.85 million cars per year--expire April 1, 1985. There has been no official discussion regarding their future.

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Steel: We reached agreement with the GOJ in December on a restraint arrangement on steel exports to the United States. Details are still being negotiated including whether the arrangement is to have a life span of five years. It is supposed to be in consonance with agreements reached with other steel exporting countries.

Fishery Relations: The U.S.-Japan fishery relationship has been affected by two major issues recently: trade and enforcement cooperation. Japan has undertaken to improve enforcement cooperation. Still it appears that initial allocations to all countries fishing in U.S. waters will be significantly lower in 1985 than in 1984 due to an expected increase in the harvest by U.S. fishermen.

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<u>U.S.-Japan Trade Statistics</u> (in billions of dollars)					
	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984*</u>	<u>1985</u> proj.
U.S. Exports to Japan	21.8	21.0	21.9	23.1	25.3
U.S. Exports to World	233.7	212.3	200.5	216.1	217.4
U.S. Exports to Japan as % of U.S. Exports to World	9.3%	9.9%	10.9%	10.7%	11.6%
U.S. Imports from Japan	37.6	37.7	41.2	58.1	61.6
U.S. Imports from World	261.3	244.0	258.0	331.9	383.6
U.S. Imports from Japan as % of U.S. Imports from World	14.4%	15.5%	16.0%	17.5%	16.1%
U.S. Trade deficit with Japan	15.8	16.7	19.3	35.0	36.3
U.S. Trade deficit with World	27.6	31.7	57.5	115.8	166.2
U.S. Trade deficit with Japan as % of U.S. Trade deficit with World	57.2%	52.7%	33.6%	30.2%	21.8%
U.S. Manufactured Exports to Japan	9.5	9.4	10.1	11.0	N/A
U.S. Manufactured Imports from Japan	36.9	37.0	40.4	57.1	N/A
U.S. Agricultural Exports to Japan	6.6	5.5	6.2	6.5	N/A
U.S. Agricultural Imports from Japan	0.1	0.1	0.2	0.2	N/A

*annualized based on January-October 1984 data. The 1984 and 1985 data has not yet been released to the public.
Source: U.S. Department of Commerce

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FINANCIAL ISSUES: YEN/DOLLAR AGREEMENT

Part of the Administration's efforts to increase foreign access to the Japanese economy has consisted of negotiations between the U.S. Treasury Department and the Japanese Ministry of Finance on financial market issues. President Reagan and Prime Minister Nakasone gave the mandate for these talks during the President's November 1983 visit to Tokyo. To fulfill this mandate, the two sides issued the Yen/Dollar Agreement in May 1984. A reminder to Prime Minister Nakasone about the commitment last November and the importance of full and prompt implementation of the agreed measures would greatly enhance the prospects for full implementation of the Agreement.

A major motivation for the Yen/Dollar negotiations was concern over the yen/dollar exchange rate. We believe that if Japan followed free market financial policies, there would be more international demand for the yen and that the yen would become a stronger currency.

The broad goals of the Yen/Dollar Agreement were to increase the international use of the yen and liberalize Japan's capital markets so that, over time, the yen will more fully reflect the underlying strength of the Japanese economy. To accomplish these goals, Japan agreed to take a series of important measures in three broad areas: the development of a Euroyen market, the liberalization of Japan's domestic capital market and increased access to the Japanese capital market for foreign financial institutions.

The Yen/Dollar Agreement represents an important milestone in getting Japan to open its markets to foreign participation and to assume a more important role in the international financial system. If fully implemented, the agreement will have important benefits for the United States. As the agreed measures go into effect, we expect the value of the yen to increase, which would help improve the competitiveness of U.S. exports. In addition, U.S. corporations will have access to new sources of financing, and the U.S. financial industry will have new market opportunities in Japan.

It is too early to draw any definitive conclusions about Japan's faithfulness to the Yen/Dollar Agreement, since the individual measures in the Agreement are to be implemented over a period of time. Although our assessment to date is generally favorable, some problem areas began to emerge during November follow-up discussions in Tokyo. These involve implementation of some of the agreed steps which, in our view, should aim at bolder and more rapid change.

Treasury will continue to monitor Japan's implementation of the Agreement very carefully. A second follow-up meeting is scheduled for the spring of 1985, by which time most of the agreed measures are scheduled to have gone into effect.

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Defense Issues

Overview: The U.S.-Japan defense relationship is going smoothly; it is probably the best it has ever been. This is a natural development, given the close overall relationship between the two countries. We are conducting combined exercises with the Japanese Self-Defense Forces; the Sealanes Defense Study should be completed this spring; and the first visit of a nuclear-powered aircraft carrier to Yokosuka took place in December. We hope that 1985 will be a year in which we can extend our defense cooperation even further. Our policy is to work together to find ways to make it easier for Japan to do this, not more difficult.

Defense Spending: The overall trend in Japanese defense spending is positive. Japan increased its defense spending by more than six percent a year during the first two Nakasone budgets. These increases came at a time of overall budgetary austerity in Japan, with most ministries and agencies seeing their budgets frozen or reduced. The Japan Defense Agency has requested a seven percent budget increase for Japan FY 85; the Cabinet's decision of this request will have been announced just before Nakasone travels to the U.S.

Carrier Night Landing Practice: The present night landing practice (NLP) site for USS Midway pilots is Atsugi Naval Air Station, in a heavily-populated area near Tokyo. The noise level is extremely disruptive for the residents of the area, but cutting the frequency of training could create a serious safety problem for the pilots. Japan's efforts to designate Miyakejima Island as the alternate NLP site suffered a major setback in November when a candidate opposing the proposal was elected village chief on the island. While we understand the problems the Japanese Government faces trying to find an alternative site, we continue to strongly express our hope that progress can be made to find a new NLP site soon.

Technology Transfer: On November 8, 1983, the U.S. and Japan exchanged notes providing for the transfer of Japanese defense-related technology to the United States. On November 6, 1984, the first meeting of the Joint Military Technology Commission (JMTC), established under the 1983 Exchange of Notes, took place. At the JMTC meeting, the Japanese agreed to discuss procedural mechanisms for technology transfer. However, there appears to be no consensus within the Japanese bureaucracy on what these procedures should be, and this could create delays on actual technology transfers. We are trying to work out these mechanisms as soon as possible in order to move forward to implement defense-related technology transfers.

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JAPANESE FOREIGN POLICY

Prime Minister Nakasone will continue to pursue a more active and visible international posture. While the Japanese continue to concentrate much of their attention and aid in Asia, they have become more visibly engaged elsewhere. The United States welcomes Japan's greater international activism, particularly outside its traditional Asian sphere of interest, in continued close partnership with the United States.

China: China's best relations with any Western country probably are with Japan. Nakasone visited China in May 1984, and a broad range of cultural, business and science contacts are underway. Japan disbursed \$350 million in loans in 1983, with a like amount pledged for FY 1984. The Chinese support Japan's position on the Northern Territory issue.

Middle East: Japan has \$47.7 billion in two-way trade with this strategic region. Japan is the only major Western power that maintains good diplomatic relations with both Iran and Iraq, and it has continued to seek ways to ameliorate the Iran-Iraq war. Japan is a major aid donor to Egypt, Pakistan, Sudan, and Turkey.

Soviet Union: Japan is interested in improving its frosty relations with the USSR, but only in tandem with the U.S. Japan continues to insist that Gromyko should visit Japan and discuss the Northern Territories issue.

Korea: South Korean President Chun's September visit to Tokyo was a positive step forward in Japan-South Korean relations. On December 31, Japan will lift the sanctions it imposed on North Korea after the Rangoon bombing.

Africa: Foreign Minister Abe's November visit to Zambia and Ethiopia foreshadows greater GOJ political activity in the region. New Japanese aid initiatives in Africa have enabled the GOJ to become a major food aid donor to the region, with some \$165 million pledged for FY 1984.

Latin America: Japan supports the Contadora approach in Central America and recently has been actively engaged in strengthening its bilateral relationships in the region. Foreign Minister Abe will visit the region immediately after attending the January 2 summit.

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Japanese Views on Pacific Cooperation

BACKGROUND

The Japanese have emphasized that PM Nakasone will be seeking joint, public "concrete steps" to demonstrate progress on Pacific Cooperation. We must retain their interest and bilateral candor, but be wary of too public or dramatic a gesture, or of proposals which will dilute our needed primary focus on trade issues.

Japanese Proposals and US Responses

Like Japan's leadership, we are aware of Pacific sensitivities. Our policy is not to force unnaturally the pace of consensus-building leading to multilateral Pacific cooperation at the governmental level, or to impose more on the ongoing process than it can bear. The best leadership in this area is the least visible. We both recognize the need to make the ASEAN 6+5 Human Resources Development project a success. In ongoing consultations with the dialogue partners we will seek to develop coordinated proposals based on existing institutions and better program coordination. Our recent contacts continue to emphasize our mutual interest, and the need for close and continuing consultations as we move toward the Jakarta meeting.

We have been told Nakasone will raise a proposal to create a US-Japan fund to support scholarly research. We are working urgently with GOJ officials to develop a multilateral framework with a strong private sector role, which could be announced by the two leaders with an invitation for others to join. Government funding, if any, should be minimal.

The Japanese may press for greater multilateral energy cooperation in the Pacific Region. Our policy is to resist these efforts to dilute our bilateral pressure on the energy trade issues, particularly coal and gas, while maintaining our cooperative role in the International Energy Agency.

The Japanese have told us they are studying additional specifics, such as a Pacific communications network, high technology research and other manpower programs. We have emphasized our willingness to work together, but underscored the need to include the others of the Pacific in initial discussions, in order to avoid provoking a negative reaction. Continuing bilateral consultations and, as appropriate, use of the existing institutions, including the ASEAN 6+5, Pacific Economic Cooperation Conference and the Pacific Science Association provide the right framework for continuing these efforts.

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SCIENCE AND TECHNOLOGY (S&T) AND NUCLEAR ISSUES

The United States and Japan have been engaged in science and technology cooperation since 1960, and our cooperation is one of the positive aspects of our overall relationship.

A prominent aspect of our historical approach to this scientific relationship has been to seek Japan's contribution, including financial, to U.S. research programs. One of our principal concerns has been the belief that Japan copies scientific and technological innovations well but fails to do much original research on its own.

As Japanese technology has come closer to the cutting edge of future technological developments, Japan increasingly has been pursuing basic scientific R&D. A Government white paper noted that Japan could be cut off from traditional sources of scientific and technical information from abroad, and concluded it must increase efforts to develop technology at home. We are considering what impact this shift will have on U.S.-Japan cooperation in science and technology. Specifically, we are conducting a U.S. Government-wide review of existing and potential Japanese strengths in science and technology over the next decade, and considering whether our objectives might be served by new or enhanced cooperative activities in these fields. This approach has received solid endorsement in the U.S.-Japan Advisory Committee report.

The S&T exchanges we have underway, particularly those in space and energy, are mutually beneficial in terms of information flow and Japanese investment in U.S. R&D projects. The Japanese are building an experiment for Spacelab and are very interested in participating in future space station development. However, the GOJ has an indigenous satellite and launch development policy which will effectively bar future purchases of foreign satellites. Both countries appear interested, however, in guarding against developments in either country which jeopardize the historically close science and technology relationship.

A 1968 agreement gives U.S. consent rights over reprocessing Japan's U.S.-origin nuclear material. We now are negotiating a new or amended agreement incorporating the more stringent provisions called for by the Nuclear Non-Proliferation Act of 1978. We have offered advance, long-term consent to reprocessing (as compared with the present case-by-case approach). Although major disagreements remain, Japanese negotiators recently said they intend to recommend submission of a revised agreement to the Diet. They had maintained this was impractical for domestic political reasons.

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U.S.-JAPAN ENERGY RELATIONS

The Joint Energy Policy Statement of November 11, 1983 by President Reagan and Prime Minister Nakasone stated that further progress could be made in trade and cooperation in coal, natural gas, and oil between Japan and the United States. We have met several times since the Joint Statement. We have established a forum for private firms to discuss increased coal trade. We have seen some limited success: metallurgical coal exports to Japan are predicted to be 14 million metric tons this year instead of the 11 or less originally envisioned. In addition, the Japanese have shown increased interest in the Beluga coal field in Alaska. Japanese firms have agreed in principle to a pre-feasibility study on natural gas from the Alaskan North Slope, and have shown interest in additional gas from the Alaskan South Coast.

Despite these positive signs, the overall results are not satisfactory. Coal trade continues to decline, despite increased coal use in Japan. The Japanese agree coal trade is important but state they have access to all the coal they need, usually at lower prices than U.S. firms offer. Although Japanese companies have agreed in principle to the study on Alaskan North Slope natural gas, they are balking at contributing enough money to make it meaningful. No agreement has been reached as yet on additional South Coast Alaskan gas; at the same time, the Japanese government appears to want to encourage the purchase of Soviet (Sakhalin) gas. The Japanese want to buy Alaskan oil, but existing U.S. law has so far blocked sales. The Japanese have not stepped-up their program to increase strategic oil stocks, despite our repeated urging.

Much remains to be done on energy. We should continue to stress the value of long-term commitments on the Japanese part to develop secure and competitive U.S. coal and gas resources, and we should signal our disappointment at the limited progress since the Joint Statement. The Japanese will have several occasions over the next few months to demonstrate their seriousness. Our bilateral energy working group will meet at the expert level in early February, our private-sector coal representatives will meet in mid February, and our full energy working group will meet in late February or early March.

Japanese utilities recently decided to continue most DOE nuclear enrichment services, which amount to about \$400 million a year. These exports are important for the viability of the U.S. enrichment industry, for U.S. non-proliferation policy, and for U.S.-Japan nuclear energy cooperation. There also has been some collaboration on research on fusion and breeder reactors and synfuels. We now are identifying other projects which could be done more efficiently in a comprehensive collaborative effort. Japan spends about \$25 million a year on joint R&D with the U.S.

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JAPANESE-SOVIET RELATIONS

Japan does not want to depart from Western consensus on relations with the Soviet Union, even though it very much wants the Northern Territories issue to be resolved. Tokyo has three other objectives: a diminution of the Soviet military threat to Japan, particularly the removal of SS-20 missiles based in Asia; a relaxation of tensions in Northeast Asia; and an improvement and upgrading of the quality of its dialogue with the USSR on a wide variety of issues.

Japan continues to regard arms control and regional stability as issues over which it has only limited control. Thus, to the extent possible, Tokyo pursues these objectives through its relationship with the US. For example, because Tokyo cannot directly affect arms control agreements which could remove the SS-20 threat, it has pursued its objectives by securing a U.S. commitment to a global approach to arms control negotiations and joining the other industrialized democracies at Williamsburg in a common position on theater and strategic nuclear weapons.

Japan's dialogue with the Soviet Union plays extremely well with the Japanese public, not because there is a large pro-Soviet constituency in Japan (there is not), but because of the public's strong desire for peace. It is important to the GOJ leadership to be perceived domestically as making every effort to reduce tensions with the Soviet Union, with the implicit understanding that major changes in the relationship are subject to developments in the larger East-West context. Thus the Abe-Gromyko UNGA meeting, the Nakasone-Tikhonov meeting, the Japan visit of Politburo member Dinmukhamed Kunayev, and the Japan-Soviet Economic Committee meetings led by Foreign Trade Minister Patolichev (December 12-15) should be seen as GOJ efforts to fill the parameters open to it to enhance its dialogue with the Soviet Union without ripping at the edges of the general East-West balance.

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KEY RECOMMENDATIONS OF THE U.S.-JAPAN ADVISORY COMMISSION

General

-- Fundamentally, the U.S.-Japan relationship is on the right course.

-- But the current, too often confrontational pattern of interaction between our two countries is eroding good will and mutual trust. We must not allow the fabric of the relationship to be damaged by preoccupation with short-term, narrowly focused controversies.

-- We need to improve mechanisms for coordinating our own policies and dealing with each other:

- o The President and the Prime Minister should regularly set and periodically review a 3-5 year agenda of issues calling for priority attention.
- o The Prime Minister and the Secretary of State should coordinate policy inputs by government agencies and the private sector, make sure that our policy is pursued with a single negotiating voice, and require faithful implementation of decisions reached by top leaders.

-- Increased popular understanding of the importance of the relationship is imperative.

Political and Security

-- The striking concordance of our respective foreign policies and Japan's increasing acceptance of a larger international role presents the U.S.-Japan partnership with new opportunities for cooperation.

-- While the security interests of the U.S. and Japan have assumed even closer identity in the face of the Soviet military build-up, a significant "strategy gap" remains because the development of strategic concepts and implementation of defense programs in Japan have not kept pace.

-- Japan should be prepared to participate in UN peacekeeping operations, including possibly the dispatch of uniformed personnel.

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Economic

-- Japan should formulate its own agenda through a "Special Commission for Strengthening the International Economy" and move on its own to assume broader global responsibilities, rather than simply respond to successive U.S. pressures.

-- Japan should overcome its "GATT allergy," and the U.S. and Japan should not hesitate to use the GATT mechanism to settle disputes.

-- A major cause of the trade imbalance has been the different macroeconomic policy mixes in Japan and the United States. It is principally on this level that the respective trade problems of the two countries must be addressed. The United States needs to reduce interest rates to help bring about a more favorable exchange rate.

-- A variety of petty, largely nontariff barriers remain in Japan, which call into question Japan's commitment to free trade or fair trade. Japan should make market access a national goal.

-- Japan should strengthen the Office of the Trade Ombudsmen (OTO) by giving it a mandate to ferret out and initiate market-opening mechanisms on its own.

-- Japan should re-structure its agricultural production towards products that can be efficiently produced on smaller-sized holdings.

-- Japan should be prepared to accept a continuing liberalizing process for beef and citrus.

-- Because of its high savings rate, Japan can contribute capital to a world needy of capital. However, the lack of integration of its capital markets with world markets inhibits the development of Japan's full potential in this regard. We regard capital liberalization as a key issue.

-- Viable energy cooperation proposals must have a solid economic base and ultimately be attractive to the private sector in both countries.

-- At a minimum, consideration should be given to legislation that would allow Alaskan oil to be exported to Japan in an oil crisis.

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